United States Courts
Southern District of Texas
FILED
MAY 0 8 2002
Michael N. Milby, Clerk

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

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| In re ENRON CORPORATION SECURITIES LITIGATION | § | |
| This Document Relates to: | § | |
| MARK NEWBY, et al., Individually and on Behalf of All Others Similarly Situated, | § | Civil Action No. H-01-3624 (Consolidated) |
| Plaintiffs, | § | |
| - against - | § | |
| ENRON CORP., et al., | § | |
| Defendants, | § | |
| THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, et al., Individually and on Behalf of All Others Similarly Situated, | § | |
| Plaintiffs, | § | |
| - against - | § | |
| KENNETH L. LAY, et al., | § | |
| Defendants. | § | |

ARTHUR ANDERSEN LLP'S
MOTION TO DISMISS THE
CONSOLIDATED COMPLAINT

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## ARTHUR ANDERSEN LLP'S MOTION TO DISMISS THE CONSOLIDATED COMPLAINT

Defendant Arthur Andersen LLP ("Andersen") respectfully moves this Court to dismiss plaintiffs' Consolidated Complaint dated April 8, 2002 pursuant to Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure.

## PRELIMINARY STATEMENT

This action arises out of the collapse of Enron Corporation ("Enron"), after its creditors, counterparties and investors lost confidence in Enron in the wake of a singular series of events: the abrupt resignation of its new CEO, significant charges to earnings, regulatory and media inquiries into certain related party transactions, an announced intent to restate its financial statements, the appointment of a special committee to investigate these events, and an abortive merger. With Enron now in bankruptcy, plaintiff shareholders and bondholders seek to hold Enron's outside auditor, Andersen – along with officers and directors of Enron, several investment banks and law firms – liable for alleged securities fraud.

However, plaintiffs do not allege facts that would support their claims against Andersen, suggesting that they are really trying to hold Andersen liable as a guarantor for Enron's business failure. In particular, plaintiffs' claim for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder falls far short of pleading fraud with the particularity required by Rule 9(b), and fails to plead the scienter required under the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Plaintiffs fail to plead particularized facts that, if proved, would give rise to a strong inference that Andersen possessed the scienter required for such a claim. In addition, plaintiffs' claim under Section 11 of the Securities Act of 1933 fails to adequately plead reliance or consent. Like plaintiffs' federal securities fraud claim, plaintiffs' claim under the Texas Securities Act fails to plead fraud with

the particularity required by Rule 9(b). Accordingly, the Consolidated Complaint should be dismissed.

## SUMMARY OF ALLEGATIONS

For purposes of deciding a motion to dismiss under Federal Rule of Civil Procedure 9(b) or 12(b)(6), the Court may accept as true only well-pleaded allegations of fact.[1] See In re Sec. Litig. BMC Software, Inc., 183 F. Supp. 2d 860, 865 n.13 (S.D. Tex. 2001). Conclusory allegations should be disregarded. See Tuchman v. DSC Communs. Corp., 14 F.3d 1061, 1067 (5th Cir. 1994).

According to the Consolidated Complaint, plaintiffs purchased Enron securities from October 18, 1998 through November 27, 2001. Compl. ¶ 1.[2] Plaintiffs allegedly made these purchases in reliance on numerous public statements made by multiple defendants throughout the alleged class period – including, among other statements, Enron's annual financial statements and unaudited quarterly financial statements, press releases by Enron, public statements by Enron officers, and reports on Enron stock by securities analysts. See, e.g., Compl. ¶¶ 121-394, 983, 986.

On November 8, 2001, Enron filed a Form 8-K with the SEC, announcing that it would restate its annual financial statements for the years 1997, 1998, 1999 and 2000, and would restate its unaudited financial statements for the first two quarters of 2001. See, e.g., Compl. ¶¶ 61, 419-21; see also 11/8/01 Enron Form 8-K (attached as Tab 76 to the Master SEC Appendix, dated May 8, 2002 ("SEC App."), filed in connection with Certain Defendants' Joint Brief Relating to

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[1] In the Fifth Circuit, motions to dismiss for failure to plead fraud with particularity under 9(b) are treated as 12(b)(6) motions. See Lovelace v. Software Spectrum, Inc., 78 F.3d 1015, 1017 (5th Cir. 1996) (citing Shushany v. Allwaste, Inc., 992 F.2d 517, 520 (5th Cir. 1993)).

[2] Plaintiffs' Consolidated Complaint dated April 8, 2002 will be cited herein as "Compl."

Enron's Disclosures).[3] This announced restatement reflected the consolidation of three special purpose entities (SPEs), namely, Chewco, Jedi, and LJM; a previously announced $1.2 billion reduction in shareholders' equity; and the inclusion of certain audit adjustments and reclassifications that Andersen previously had proposed to Enron, but had determined previously to be immaterial.

In the wake of Enron's announced intent to restate these financial statements, plaintiffs allege that the financial statements did not conform to generally accepted accounting principles ("GAAP") and thus were "false and misleading." See, e.g., Compl. ¶¶ 155, 214, 300, 339, 386, 903-904. Plaintiffs claim that these allegedly false financial statements – together with the other alleged misstatements on which they claim to have relied – were part of a "massive" fraud, Compl. ¶ 898, perpetrated by Enron and its officers and directors, allegedly with the assistance of its lawyers, bankers, and outside auditor, Andersen. Compl. ¶¶ 70, 393.

As Enron's outside auditor, Andersen is alleged to have audited the annual financial statements and "reviewed interim [19]97 through [20]01 results and press releases." Compl. ¶ 897. Plaintiffs allege that Andersen's audits of the annual financial statements violated generally accepted auditing standards ("GAAS"). Compl. ¶¶ 899, 905. Plaintiffs also allege that Andersen knew of or was "involved in" the accounting for several transactions whose accounting allegedly did not conform to GAAP. See, e.g., Compl. ¶¶ 935, 946, 947, 950, 951(c).

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[3] The content of documents incorporated by reference or referred to in the complaint may properly be considered by the Court on a motion to dismiss. See Lovelace, 78 F.3d at 1017; BMC Software, 183 F. Supp. 2d at 881. The Court may also take judicial notice of and consider the contents of relevant documents that are filed with the SEC. See Lovelace, 78 F.3d at 1018; BMC Software, 183 F. Supp. 2d at 882.

## ARGUMENT

### I. THE CONSOLIDATED COMPLAINT FAILS TO ADEQUATELY PLEAD A SECURITIES FRAUD CLAIM AGAINST ANDERSEN UNDER SECTION 10(b) OF THE SECURITIES ACT OF 1934 OR SEC RULE 10b-5

Plaintiffs claim that Andersen should be held liable under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 for alleged "complicity in" an alleged "massive" fraud by Enron and other defendants. But this attempt must fail as a matter of law because theories of secondary liability are not available to private plaintiffs under Section 10(b) or Rule 10b-5.

Plaintiffs also charge Andersen with securities fraud on the basis of its audit reports on Enron's annual financial statements for the years ending 1997 through 2000. But these allegations do not satisfy either the particularity requirement of Rule 9(b) of the Federal Rules of Civil Procedure or the requirement under the PSLRA that plaintiffs plead facts that support a strong inference of scienter. As explained below, plaintiffs have therefore not alleged a sufficient basis for liability under Section 10(b) and Rule 10b-5.

#### A. Andersen Cannot Be Held Liable for Alleged "Involvement in"Alleged Fraud by Enron and Others

In Central Bank v. First Interstate Bank, 511 U.S. 164 (1994), the United States Supreme Court held that "a private plaintiff may not maintain an aiding and abetting suit under § 10(b)." Id. at 191. Following Central Bank, courts have held that "in order for the defendant to be primarily liable under § 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been *publicly attributable to the defendant* at the time that the plaintiff's investment decision was made." Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001) (emphasis added); accord Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d

Cir. 1998); see also Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1225 (10th Cir. 1996). This is a bright line rule. "Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b)." Wright, 152 F.3d at 175 (internal quotations omitted).[4]

The vast bulk of the Consolidated Complaint is devoted to allegations that defendants other than Andersen engaged in fraud, and that Andersen was "involved in," "complici[t]" in, "help[ed] Enron perpetrate," and "collaborat[ed] with Enron, its lawyers and bankers" in this alleged fraud. See, e.g., Compl. ¶¶ 1-896, 897-898, 911, 912, 913, 918, 941. Even if plaintiffs' allegations against other defendants were sufficient to plead fraud, allegations that Andersen participated in the alleged fraud of others are not a basis for liability under section 10(b). See Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997) ("Allegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms used throughout the complaint all fall within the prohibitive bar of Central Bank."); see also In re HI/FN, Inc., Sec. Litig., No. C 99-4531 SI, 2000 U.S. Dist. LEXIS 11631, at *35 (N.D. Ca. Aug. 9, 2000) ("allegations of a scheme to defraud by individual defendants who are not alleged to have made statements do not support a claim for violation of §10(b)").

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[4] Among Courts of Appeals to have addressed the issue, the Ninth Circuit – which initially decided the issue in a footnote – is the lone exception that does not follow this bright line rule. See In re Software Toolworks, Inc., 50 F.3d 615, 628 n.3 (9th Cir. 1994) (holding accountants may be liable for statements made by others where the accountants reviewed the statements and played a "significant role" in the drafting and editing of the statements). However, even if there were § 10b liability for a "significant role" in others' statements, plaintiffs have not adequately pled such participation by Andersen. See infra Section III.

In Vosgerichian v. Commodore Int'l, 862 F. Supp. 1371 (E.D. Pa. 1994), for example, the plaintiffs alleged that Andersen participated in its client's structuring of allegedly fraudulent transactions:

> "Plaintiff states that Commodore 'consulted Arthur Andersen' and that 'AA advised or concurred with Commodore's decision to treat the re-purchases as equity transactions.' He also maintains that 'Commodore, with AA's guidance and express approval, effectively paid Prudential an additional $9 million in interest without ever recording any expense.' He further states, 'AA provided direct and substantial assistance to Commodore in misrepresenting the true nature of the Prudential transactions.'"

Id. at 1378 (citations omitted). Following Central Bank, the court rejected these allegations as a basis for liability under Section 10(b), reasoning:

> "Each and every misrepresentation alleged was made by Commodore. Plaintiff's allegations against AA do not go beyond allegations that AA assisted Commodore in perpetrating securities fraud and are thus not cognizable."

Id. For the same reasons, Andersen cannot be held liable here for allegedly assisting Enron and other defendants in making alleged misstatements.

B. An Auditing Firm Cannot Be Held Liable for Securities Fraud Absent, at a Minimum, Recklessness So Severe as to Constitute Fraud at the Time It Issued Its Audit Reports

"In order to state a claim under section 10(b) of the 1934 Act and Rule 10b-5, a plaintiff must allege, in connection with the purchase or sale of securities, "(1) a misstatement or an omission (2) of material fact (3) made with scienter (4) on which plaintiff relied (5) that proximately caused [the plaintiffs'] injury." Nathenson v. Zonagen Inc., 267 F.3d 400, 406-07 (5th Cir. 2001) (quoting Tuchman, 14 F.3d at 1067).

The only statements publicly attributable to Andersen that the Consolidated Complaint alleges were "false and misleading" are Andersen's reports on Enron's *annual* consolidated

financial statements for 1997, 1998, 1999 and 2000, and its subsequent consents to include those financial statements in registration statements and prospectuses. See Compl. ¶¶ 899, 903-905. Significantly, the last of these reports was issued on February 23, 2001.[5] Compl. ¶ 903. Plaintiffs allege that Andersen "performed reviews" of Enron's quarterly financial statements, "reviewed and approved" Enron's quarterly reports and "reviewed, discussed and approved" Enron's press releases, but these alleged actions entailed no statements publicly attributable to Andersen, and thus are not a basis for principal liability under Central Bank. See, e.g., Wright, 152 F.3d at 175.

Andersen's reports on Enron's annual financial statements expressed Andersen's "opinion," "based on [its] audits" that the statements "present fairly, in all material respects, the financial condition of Enron Corp. and subsidiaries . . . in conformity with accounting principles generally accepted in the United States." Compl. ¶ 903. In issuing such an opinion, an auditor neither acts as guarantor of its client's financial statements, nor represents that its audit was perfect. See, e.g., AU § 230.13 (attached as Ex. C to Declaration of Andrew Ramzel in Support of Defendant Arthur Andersen LLP and The Individual Andersen Defendants' Motions to Dismiss ("Ramzel Decl.")) ("the auditor is not an insurer and his or her report does not constitute a guarantee").[6] Rather, "the auditor certifies only that it exercised appropriate, not flawless, levels of professional care and judgment." In re IKON Office Solutions, Inc., 277 F.3d 658, 673 (3d Cir. 2002).

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[5] According to plaintiffs' allegations, Andersen last granted consent to use its name in connection with audited financial statements in a prospectus filed on July 25, 2001. Compl. ¶ 899.

[6] The American Institute of Certified Public Accountants' Auditing Standards are cited as "AU." These standards are "recognized by the AICPA as the interpretation of GAAS." Compl. ¶ 902.

As a result, there is a "demanding threshold" for holding an auditor liable for securities fraud:

> "[T]o give rise to section 10(b) liability for fraud, the mere second-guessing of calculations will not suffice; appellants must show that [the auditor's] judgment – *at the moment exercised* – was sufficiently *egregious* such that a reasonable accountant reviewing the facts and figures should have concluded that [the company's] financial statements were misstated and that as a result the public was likely to be misled. Cf. Denny v. Barber, 576 F.2d 465, 470 (2d Cir.1978) (rejecting 'fraud by hindsight' because the law does not expect clairvoyance)."

Id. (emphases added). The mental state required for securities fraud liability – scienter – is

> "limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it."

Nathenson, 267 F.3d at 408 (internal quotations and citation omitted).

This standard requires intentional deceit or severe recklessness. See Nathenson, 267 F.3d at 407. Recklessness "differs from negligence not only in degree, but also in kind," In re Barry C. Scutillo, S.E.C. Docket 1944, Rel. No. ID-183, 2001 WL 461287, at *26 (May 3, 2001), and "no degree of negligence can satisfy the substantive element of scienter, or raise a strong inference of scienter under the [PSLRA]." Reiger v. PricewaterhouseCoopers, 117 F. Supp. 2d 1003, 1014 (S.D. Cal. 2000), aff'd sub nom, DSAM Global Value Fund v. Altris Software, Inc., ___ F.3d ___, 2002 WL 598417, at *5 (9th Cir. Apr. 19, 2002) ("[n]egligence, even gross negligence, does not rise to the level of the nefarious mental state necessary to constitute securities fraud under the PSLRA"); see also McLean v. Alexander, 599 F.2d 1190, 1198 (3d Cir. 1979) ("[N]egligence, whether gross, grave or inexcusable cannot serve as [a] substitute for scienter."). In this context, a plaintiff "cannot bootstrap its way to victory in an auditing

recklessness case by stringing together separate acts of auditing negligence." Scutillo, 2001 WL 461287, at *26.

As demonstrated below, plaintiffs' allegations suggest nothing more than that Andersen, due to accounting errors or lack of timely information, mistakenly concluded that Enron's audited financial statements comported, in all material respects, with GAAP. These allegations fall far short of showing that "at the moment exercised" Andersen's judgment was so egregiously wrong as to evidence severe recklessness. See IKON, 277 F.3d at 673.

C. Plaintiffs Have Not Adequately Alleged that Andersen Is Liable as a Principal Under Section 10(b) or Rule 10b-5

Although the Consolidated Complaint is long on words, it is short on the type of particularized allegations against Andersen required by Rule 9(b) and the PSLRA. The lengthy narrative creates the illusion of particularity, but closer scrutiny reveals the absence of details necessary to plead a claim of securities fraud against Andersen. See Williams v. WMX Techs., Inc., 112 F.3d 175, 178 (5th Cir. 1997) ("A complaint can be long-winded, even prolix, without pleading with particularity. Indeed, such a garrulous style is not an uncommon mask for an absence of detail"). As this Court has held, "conclusory allegations or legal conclusions masquerading as factual conclusions do not defeat a motion to dismiss." BMC Software, 183 F. Supp. 2d at 865 n.13.

1. The Consolidated Complaint Fails to Plead Fraud by Andersen with the Requisite Particularity

a. The PSLRA and Federal Rule of Civil Procedure 9(b) Impose Stringent Particularity Requirements for Pleading Federal Securities Fraud

The PSLRA and Federal Rule of Civil Procedure 9(b) impose strict pleading requirements on plaintiffs asserting federal securities fraud claims. "To satisfy Rule 9(b) and the PSLRA, a plaintiff must plead facts and avoid reliance on conclusory allegations." Schiller v. Physicians Res. Group, Inc., No. Civ.A. 3:97-CV-3158-L, 2002 WL 318441, at *4 (N.D. Tex. Feb. 26, 2002). Under Rule 9(b), "[c]ourts have uniformly held inadequate a complaint's general averment of the defendant's knowledge of material falsity unless the complaint also sets forth specific facts that make it reasonable to believe that defendant knew that a statement was false or misleading." Coates v. Heartland Wireless Communs., Inc., 55 F. Supp. 2d 628, 634 (N.D. Tex. 1999) (internal quotations and citations omitted); see also Lovelace, 78 F.3d at 1018 ("In order to adequately plead scienter [under Rule 9(b)], a plaintiff must set forth specific facts to support an inference of fraud.").

The PSLRA heightens the Rule 9(b) standard. See Schiller, 2002 WL 318441, at *4; BMC Software, 183 F. Supp. 2d at 865 n.15. In particular, the PSLRA states that "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1)(B).

Further, plaintiffs are not permitted to group defendants together in undifferentiated allegations. As this Court has explained, "[b]ecause . . . a more stringent pleading is required by the PSLRA, [this Court] agrees with those district courts that find the group pleading doctrine is at odds with the PSLRA and has not survived the amendments." BMC Software, 183 F. Supp. 2d at 901 n.45; see also Marra v. Tel-Sav Holdings, Inc., 1999 U.S. Dist., LEXIS 7303, *14 (E.D. Pa. May 18, 1999) (citing Coates v. Heartland Wireless Communs., Inc., 26 F. Supp. 2d 910, 916 (N.D. Tex. 1998)). Thus, the PSLRA "requires plaintiffs to distinguish among those they sue and enlighten each defendant as to his or her particular part in the alleged fraud." Schiller, 2002 WL 318441, at *5 (internal quotations and citation omitted).

In order to satisfy the pleading requirements of the PSLRA and Rule 9(b), the complaint must adequately demonstrate that *each* defendant possessed the requisite state of mind or scienter. The PSLRA expressly requires that "the complaint shall, with respect to *each* act or omission alleged to violate this chapter, state with particularity *facts* giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphases added). An artificial person such as a corporation or partnership that can only act through its human agents "can be held to have a particular state of mind *only* when that state of mind is possessed by a *single* individual." First Equity Corp. v. S&P Corp., 690 F. Supp. 256, 260 (S.D.N.Y. 1988) (emphases added). Thus, plaintiffs cannot satisfy the applicable stringent requirements for pleading scienter by referring generally to the partnership without identifying specific acts, omissions, or knowledge of particular partners or employees. See Schiller, 2002 WL 318441, at *5-6; accord BMC Software, 183 F. Supp. 2d at 913 n.50.

Prior to the PSLRA, a plaintiff merely had to plead facts that "support an inference of fraud"; to meet the heightened requirement of pleading a "strong inference" a plaintiff must now

allege facts demonstrating intentional misconduct or severe recklessness. See Nathenson, 267 F.3d at 407; see also DSAM Global Value Fund, 2002 WL 598417, at *2 (plaintiffs must plead "in great detail" facts showing "deliberately reckless or conscious misconduct") (internal quotation marks omitted). Allegations of a defendant's motive and opportunity to commit fraud will not suffice to plead scienter under the PSLRA. See id. at 410-12. Nor can a plaintiff plead scienter by merely alleging participation in a fraud based on the defendants' executive positions, access to internal corporate documents, day-to-day responsibilities, attendance at management and board meetings and/or the location of their office. See BMC Software, 183 F. Supp. 2d at 885. Rather, plaintiffs "must allege what actions each Defendant took in furtherance of the alleged scheme and specifically plead what he learned, when he learned it, and how plaintiffs know what he learned." Id. at 886. In addition, "Plaintiffs may not rely on fraud by hindsight to establish a claim for securities fraud . . . or seize upon disclosures in later reports and allege they should have been made in earlier ones." Schiller, 2002 WL 318441, at *10 (internal quotations and citations omitted).

The failure of an auditor to discover fraud by its client does not imply that the auditor committed fraud, or even violated GAAS. As recognized under GAAS:

> "Because of the characteristics of fraud, particularly those involving concealment and falsified documentation . . ., a properly planned and performed audit may not detect a material misstatement. . . . [A]uditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion among client personnel and third parties or among management and employees of the client."

AU § 230.12 (attached as Ex. C to Ramzel Decl.).

b. The Consolidated Complaint Does Not Satisfy These Stringent Particularity Requirements

Plaintiffs ground their securities fraud claims against Andersen in allegations that Enron's financial statements did not conform to GAAP and that Andersen's audits did not comply with GAAS. But it is well-established – even under the less stringent pre-PSLRA standards – that alleging GAAP or GAAS violations is insufficient to state a claim for securities fraud. See, e.g., Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994); Ziemba, 256 F.3d at 1209 ("In order to plead fraud with sufficient particularity to satisfy Rule 9(b), plaintiffs must therefore allege more than mere violations of auditing standards"); In re Comshare, Inc. Sec. Litig., 183 F.3d 542, 553 (6th Cir. 1999) ("The failure to follow GAAP is, by itself, insufficient to state a securities fraud claim"); accord Coates v. Heartland Wireless Communs., Inc., 100 F. Supp. 2d 417, 430 (N.D. Tex. 2000); see also DSAM Global Value Fund, 2002 WL 598417, at *1 (allegations of "seriously botched" audit are insufficient to plead scienter under the PSLRA); Zucker v. Sasaki, 963 F. Supp. 301, 307 (S.D.N.Y. 1997) ("[G]eneral allegations of GAAP and GAAS violations fail to satisfy the scienter requirements of Section 10(b) and Rule 10b-5.").

As demonstrated below, plaintiffs do not show that the alleged departures from GAAP and GAAS were intentional or severely reckless, as opposed to the result of bad judgment. There are almost no specific allegations concerning who worked on the Enron audits and who was responsible for making decisions regarding the issuance of the audit opinions. "Andersen" is generally charged with knowledge without any identification of the individuals at Andersen who allegedly possessed this knowledge, or when they learned it or "specific facts that make it

reasonable to believe that [those individuals] *knew* that a statement was false or misleading." Coates, 55 F. Supp. 2d at 634 (emphasis added).[7]

Instead, plaintiffs attribute knowledge to "Andersen" in general, principally on the basis of the amount of time Andersen's personnel devoted to Enron, implicitly or explicitly alleging that if Andersen did not possess the alleged knowledge, it should have possessed it. But a partnership like Andersen necessarily acts through its partners or employees and, as noted above, a partnership can be imputed with a mental state "*only* when that state of mind is possessed by a *single* individual." First Equity Corp., 690 F. Supp. at 260 (emphases added). In this context, the Consolidated Complaint fails to allege particularized facts that give rise to a strong inference of scienter, much less identify a particular individual, or individuals, possessing the requisite scienter. The complaint further fails to detail how Andersen arrived at its decisions to issue its audit reports, identify who was involved in those decisions, or specify what those individuals knew at the time those decisions were made. Under these circumstances, plaintiffs have utterly failed to plead facts showing individuals' mental states "at the moment[s]" that they made the challenged statements, see IKON, 277 F.3d at 673, much less that any individual or Andersen was severely reckless at that time.

Plaintiffs' allegations address Andersen's relationship with Enron in general, as well as several different Enron entities and transactions. A review of these allegations by topic demonstrates that they omit particularized allegations of fact that would give rise to a strong inference of scienter.

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[7] Plaintiffs have failed to allege a claim under Section 10(b) or Rule 10b-5 against any of the individual Andersen defendants. See Motion of the Individual Andersen Defendants to Dismiss Count I of Plaintiffs' Consolidated Complaint, dated May 8, 2002.

i. Plaintiffs' Allegations Regarding Andersen's Relationship with Enron Do Not Give Rise to a Strong Inference that Individuals at Andersen Possessed Scienter (Responding to Sections A-D, F, I and K-M)[8]

Plaintiffs' allegations regarding Andersen's receipt of fees from Enron show neither lack of independence nor motive to commit fraud. Plaintiffs try to support their assertion that Andersen lacked independence principally by alleging that Enron was Andersen's second largest client and, as such, was an "extremely lucrative" relationship. Compl. ¶¶ 906-907. Plaintiffs allege that Andersen received $52 million in fees from Enron in 2000, but plaintiffs neither specify the percentage of Andersen's total revenue that the Enron fees constituted nor do they compare these fees to those earned by other big accounting firms. See Compl. ¶ 906. Perhaps because plaintiffs recognize that $52 million was not a significant portion of Andersen's total revenues, they instead resort to the conclusory allegation that this was an "incredible" level of fees. Compl. ¶ 906. In any event, it is well-settled that an auditor's expectation of continued compensation does not establish the severe recklessness necessary for securities fraud liability. See Melder, 27 F.3d at 1103. "A contrary conclusion would universally eliminate the state of mind requirement in securities fraud actions against accounting firms. This follows from the indisputable proposition that accounting firms – as with all rational economic actors – seek to maximize their profits." Id.

Plaintiffs' suggestion that Andersen was dependent on its relationship with Enron, see Compl. ¶ 906, is further undermined by their allegations regarding the size and structure of

[8] The allegations pertaining to Andersen are relegated to the end of the nearly 500-page Consolidated Complaint and are divided into thirteen sections, A through M.

Andersen and the foreign entities' worldwide operations (including Andersen as well as its legally separate affiliates). According to the Consolidated Complaint, these operations encompassed 77,000 employees, 4,800 partners in 390 offices in 84 countries. Compl. ¶ 973(a), 974. More importantly, Andersen and the foreign affiliated entities allegedly conducted over 30,000 audits per year, of which the Enron engagement was but one. See Compl. ¶ 974. Plaintiffs' allegations do not support the notion that Andersen intentionally risked its international reputation in order to engage in intentional deceit, or recklessness so severe as to constitute fraud, for the benefit of Enron. See Melder, 27 F.3d at 1103 ("An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work.") (quoting DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990)). For these same reasons, plaintiffs do not adequately allege any motive for Andersen to have engaged in the alleged fraud.

Plaintiffs allege that "Andersen's close working relationship with [Enron's] management" contributed to a lack of independence. Compl. ¶ 914. But auditors must work closely with management including, for example, in order to obtain a thorough understanding of management's objectives. Contrary to plaintiffs' reasoning, GAAS recognizes that a "[s]trained relationship between management and the current or predecessor auditor" is a "risk factor" for fraud. See AU § 316.17(a) (attached as Ex. D to Ramzel Decl.).

Plaintiffs further allege that Enron employed numerous former Andersen employees, and suggest that the presence of Andersen alumni at Enron was conducive to fraud. See Compl. ¶ 914. This suggestion is undermined by plaintiffs' allegation that it was an Andersen alumna, Enron Vice President Sherron Watkins, who in August 2001 raised concerns about the "very issues that caused Enron's collapse" – first with a former colleague at Andersen, James Hecker,

and then with Enron's Chairman. See Compl. ¶¶ 933-34. According to the August 21, 2001 memorandum by Mr. Hecker that plaintiffs selectively quote in the Consolidated Complaint:

> "I encouraged [Ms. Watkins] to discuss these issues with anyone in the company who could satisfy her about the accounting and disclosures related to these transactions. I told her that I admired her 'stand-up' attitude and that corporate introspection about these sorts of accounting and reporting issues often was very healthy and should not be suppressed."

8/21/01 Hecker Mem. at 4 (attached as Ex. A to Ramzel Decl.). Plaintiffs' allegation that Ms. Watkins' concerns were "ignored" by Andersen is contradicted by their acknowledgment that Mr. Hecker immediately relayed Ms. Watkins' concerns to partners on the Enron engagement team, see Compl. ¶ 933, and that within less than three months Enron announced that it would restate its financial statements, see Compl. ¶¶ 61, 419-21. The restatement tends to negate any inference of scienter. See Reiger, 117 F. Supp. 2d at 1013.

In any event, Andersen's knowledge of Ms. Watkins' concerns in no way implies fraud by Andersen because plaintiffs do not allege that Andersen – which last issued an audit report on Enron's financial statements on February 23, 2001 – made any public statements about Enron's finances *after* becoming aware of these concerns. See IKON, 277 F.3d at 670 (evidence that auditor "deliberately disregarded" concerns about accounting raised in 1998 had no bearing on auditor's "preparation of its audit opinion in 1997, the only time-period where [the auditor's] state of mind is relevant to the section 10(b) claim"); Schiller 2002 WL 318441, at *14 (although there were indications that defendants "were aware of a number of accounting inaccuracies," there was no indication that defendants "knew or recklessly disregarded . . . accounting errors at the [earlier] time these 'errors' were made").

Plaintiffs likewise try to twist Andersen's diligence in evaluating the risk of retaining Enron as a client into an indication of fraud. Risk assessment is a part of an annual consideration

of whether the firm should retain a client. Accordingly, in February 2001, a group of Andersen executives conducted a review and assessment of Andersen's future relationship with Enron. See Compl. ¶ 930. Plaintiffs allege that this meeting reveals that Andersen knew of "red flags," but "given the lucrative nature of the Enron engagement, Andersen decided to continue to keep Enron as a client." Compl. ¶ 931. But at the meeting, as plaintiffs allege, the participants discussed several complex accounting issues relating to the Enron engagement and identified potential risks, see Compl. ¶ 930, but ultimately concluded to retain Enron as a client because they believed that Andersen "had the appropriate people and processes in place to serve Enron and manage our engagement risks." Compl. ¶ 912. The conclusion that Andersen was appropriately managing the audit risk – whether right or wrong in hindsight – negates any inference of severe recklessness *at the time*. See, e.g., IKON, 277 F.3d at 670 ("the relevant inquiry is bad faith not judgment.").

Similarly, plaintiffs allege that during another routine risk assessment conducted in October 2001 – within a month of Enron's announced intent to restate its financial statements – the test revealed that there was a "heightened" risk of fraud associated with Enron's financials. Compl. ¶ 926. Again plaintiffs fail to allege that Andersen made any public statements about Enron after October 2001. Plaintiffs assert, without any supporting factual allegations, that "Andersen . . . knew these factors were present throughout the Class Period as well." Compl. ¶ 926. But the failure to "match any of these general averments with any particularized facts that support the claim that Andersen knew or recklessly disregarded this information at the time it conducted its audits" is fatal to these allegations. Schiller, 2002 WL 318441, at *15.

Plaintiffs allege that Andersen proposed that Enron make certain accounting adjustments, but did not insist on these adjustments because Andersen determined they were immaterial.

Compl. ¶ 955. Plaintiffs allegations do not support any inference that this routine occurrence entailed fraud by Andersen. Indeed, when Andersen's staff auditors compiled a list of accounting adjustments, Andersen did not "disregard" it but, to the contrary, proposed to Enron that the company make the adjustments. See Compl. ¶ 955. Andersen did not insist, however, because it calculated – using "normalized earnings" for the proposed 1997 adjustments – that the proposed adjustments were not material. See Compl. ¶ 955. In order to make these calculations seem unprecedented – and thus suggest Andersen's actions were somehow fraudulent – plaintiffs allege that auditors "universally" calculate proposed adjustments as a percentage of net income. Compl. ¶ 955. But this categorical contention is contradicted by GAAS, which expressly provides:

> "In certain circumstances, a quantitative measure of materiality based on after-tax income from continuing operations may not be appropriate. The auditor may identify another element or elements that are appropriate in the circumstances or may compute an amount of current-year after-tax income from continuing operations adjusted to exclude unusual or infrequently occurring items of income or expense."

AU § 9312.13 (attached as Ex. E to Ramzel Decl.). Further, GAAS provides that "[t]he selection of an alternate element or elements for use in assessing a quantitative measure of materiality is a matter of the auditor's *professional judgment*." Id. § 9312.14 (emphasis added). In this context, plaintiffs have pleaded no facts suggesting that Andersen's actions were anything other than a valid exercise of its professional judgment.

Contrary to plaintiffs' suggestions, Andersen's role as Enron's internal auditor is not an indication of scienter. As plaintiffs expressly allege, the practice was sanctioned by the AICPA. Compl. ¶ 915. In any event, plaintiffs allege that Andersen served in this capacity in the early to

mid-1990's, which was significantly prior to the issuance of any of the audit reports at issue. Compl. ¶ 915.

Plaintiffs' reliance on Paul Volcker's proposed reforms are similarly unavailing. The allegation that Paul Volcker proposed reforms to Andersen's policies does not establish that Andersen had committed intentional misconduct or that it had been severely reckless in the past. Regardless, subsequent remedial measures cannot be introduced as evidence of prior fault. See Fed. R. Evid. 407.

Finally, plaintiffs allege that Andersen destroyed documents "that could implicate them on the Enron Fraud." Compl. ¶ 962. But as with the rest of the Consolidated Complaint, these allegations are conclusory and speculative. For example, the allegation that "[f]rom the day a young college recruit begins work at Andersen as an auditor, and throughout his or her entire career, document destruction or, to use Andersen staffers' clever euphemism, 'complying with the firm's retention policy,' is a mantra that is formally taught and formally and informally enforced by policy and practice at every turn throughout an auditor's career at Andersen." Compl. ¶ 963. This accusation might have shock value but it is completely unsupported by any particular factual allegations concerning Andersen's document retention policy, the training of new employees or the nature of enforcement of this so-called "mantra." Plaintiffs are clearly trying to capitalize on the headlines regarding the document issues and the criminal trial now ongoing in this Court – but notwithstanding the 10 depositions that plaintiffs have taken on the subject of document destruction, they have not transformed those headlines into particularized allegations of fact.

Moreover, plaintiffs fail to plead particularized facts that, if proved, would demonstrate that Andersen's document destruction was improper when it supposedly began in September

2001. Compl. ¶ 962. In particular, while plaintiffs allege conclusorily that "[d]uring the Summer and Fall of [20]01" Andersen believed that litigation was "imminent," plaintiffs do not allege any specific facts showing that any individual at Andersen anticipated litigation when the destruction purportedly began. See Compl. ¶ 964. For example, the allegation that Andersen "audit specialists" concluded in mid-September 2001 that unidentified memoranda approving certain Enron accounting decisions were incorrect in unspecified respects does not establish that anyone at Andersen had concluded that litigation would ensue. See Compl. ¶ 962. Under the circumstances, plaintiffs' allegations regarding document destruction do not give rise to a strong inference of scienter. To the contrary, the allegations that document destruction began in September 2001, before anyone at Andersen anticipated litigation, and ended on November 9, 2001, when Andersen actually received an SEC subpoena, undermine any inference of scienter.

Overall, plaintiffs' unsupported allegations regarding Andersen's relationship with Enron are inadequate to establish a strong inference of scienter against Andersen.

ii. Plaintiffs' Allegations Regarding Special Purpose Entities Do Not Give Rise to a Strong inference That Any Individual at Andersen Possessed Scienter (Responding to Section H)

Enron's November 8, 2001 announcement that it would restate its financial statements for 1997 through 2000 and for the first and second quarters of 2001 reflected, in part, the company's conclusion that "three [SPES] did not meet certain accounting requirements and should have been consolidated." 11/8/2001 Enron Form 8-K, at 4-5 (attached as Tab 76 to SEC App.). The SPEs at issue were Chewco, JEDI and LJM. See id.

Chewco/JEDI. With respect to Chewco and JEDI, plaintiffs allege that the non-consolidation of these two SPEs resulted in "Enron fail[ing] to record losses from and debt attributed to these two entities" in violation of GAAP. Compl. ¶ 447. In attempting to suggest that the non-consolidation of Chewco and JEDI entailed fraud by Andersen, plaintiffs allege that "Andersen knew that Chewco's general partners were senior financial employees at Enron" and that "Andersen was given documentation showing [a] reserve" that allegedly was a "red flag" that Chewco (and, as a result, JEDI) should have been consolidated. Compl. ¶ 946.

But none of these so-called "red flags" show that Andersen "consciously entertained doubts about the veracity of its client's financial disclosures, either from a client or third party informing the accountant of the client's fraud, or from contemporaneous statements made by the accountant." Reiger, 117 F. Supp. 2d at 1012. Rather here, as in Reiger, "Plaintiffs' purported 'red flags' consist of [Andersen's] possession of documentation which, if properly reviewed pursuant to GAAP and GAAS, would have revealed improper [accounting]. At most, these allegations raise an inference of gross negligence, but not fraud." Id.

Regardless, plaintiffs fail to allege that Andersen knew of these "red flags" at any specific time. This omission is fatal to any inference of fraud. See, e.g., BMC Software, 183 F. Supp. 2d at 886 (plaintiffs "must allege what actions *each* Defendant took in furtherance of the alleged scheme and specifically plead what he learned, when he learned it, and how plaintiffs know what he learned") (emphasis added). It is obvious that Andersen learned of facts supporting consolidation of Chewco and JEDI before the November 8, 2001 announcement that Enron's financial statements would be re-stated to consolidate these SPEs. Absent any specific allegation when Andersen gained this knowledge, there can be no inference of fraud by Andersen

whatsoever.[9] Schiller, 2002 WL 318441, at *10 ("Plaintiffs may not rely on fraud by hindsight to establish a claim for securities fraud . . . or seize upon disclosures in later reports and allege they should have been made in earlier ones") (internal quotations and citations omitted). Further, plaintiffs fail to identify who at Andersen allegedly knew of these "red flags." Absent these key details, plaintiffs' allegations about Andersen's knowledge of "red flags" do not satisfy Rule 9(b), and do not imply fraud by Andersen. See id. at *15 ("nowhere does the complaint plead with sufficient particularity facts that support how Andersen knew or became aware of these 'red flags'"); IKON, 277 F.3d at 671 n.13 ("[N]othing in the record suggests that anyone from [the auditor] was aware of this memo [arguably instructing the client's employees to commit accounting fraud] as of December 24, 1997, when the final audit opinion issued").

LJM1 and LJM2. Plaintiffs' allegations regarding the LJM partnerships are similarly flawed. Plaintiffs allege that "in the course of performing tens of thousands of hours of work" on transactions involving these partnerships, Andersen "noticed" and "could clearly see" alleged "red flags" regarding LJM2 (but not LJM1). Compl. ¶¶ 948-949. Once again, absent allegations regarding the specific dates that Andersen "noticed" these "red flags" and regarding the identities of the individuals who "saw" them, plaintiffs allegations are inadequate, and do not imply fraud by Andersen.

Plaintiffs also allege that certain individual defendants were involved in the structuring of, and accounting for, LJM2 and were aware that Carl Bass, an Andersen accountant, "disagree[ed]" with unspecified aspects of Enron's accounting for LJM2 beginning in 2000.

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[9] When plaintiffs become specific about a time period in an allegation, they equivocate about whether Andersen had knowledge at that time. See Compl. ¶ 946 (at the end of 1997 "Andersen recognized *or should have recognized* that virtually every aspect of the deal carried a red flag"). That Andersen "should have recognized" a red flag does not constitute an allegation of scienter and is thus insufficient to give rise to a claim under section 10 (b).

Compl. ¶ 950. Plaintiffs suggest that this disagreement, and other differences of opinion over the application of accounting principles to Enron's financial statements,[10] are indications of fraud. A proper perspective on GAAP, however, shows that debate among accountants about the proper application of GAAP to particular transactions is a sign of diligence, not of fraud. "GAAP is a term of art that encompasses a wide range of acceptable procedures." IKON, 277 F.3d at 675 n.22. As the Supreme Court has explained:

> "Accountants long have recognized that 'generally accepted accounting principles' are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. 'Generally accepted accounting principles,' rather, tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management."

Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 544 (1979); see also In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1549 (9th Cir.1994) (en banc) (as accounting concepts are flexible, circumstances will give rise to fraud only where differences in calculations are the result of a falsehood, "not merely the difference between two permissible judgments"); Godchaux v. Conveying Techniques, Inc., 846 F.2d 306, 315 (5th Cir.1988). As a result,

> "[A] difference in judgment about generally accepted accounting principles does not establish conscious behavior on the part of Defendants. The term generally accepted accounting principles, as we have often noted, is a term of art encompassing a wide range of acceptable procedures, such that an ethical, reasonably diligent accountant may choose to apply any of a variety of acceptable accounting procedures when that accountant prepares a financial statement."

Lovelace, 78 F.3d at 1021 (internal quotations and citation omitted). Also, under GAAS, an auditor is required to be skeptical. See AU § 230.07 (attached as Ex. C to Ramzel Decl.) ("Due professional care requires the auditor to exercise *professional skepticism*.") (emphasis in

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[10] Plaintiffs also allege that Bass "express[ed] his opposition" to unspecified aspects of Enron's accounting, "express[ed] his opinion" that an unspecified SPE had "no substance," and "thought the Raptor accounting was improper." Compl. ¶¶ 913, 928-929, 952(c).

original). In this context, debate among auditors and accountants is a natural part of the auditing process. If an auditor could be sued for fraud based on allegations that they were "aware" of disagreement, then diligence would become a basis for liability, and auditors would have a huge incentive not to consult colleagues on accounting issues and thus avoid awareness of divergent views.

Raptors. Plaintiffs allege no fact that, if proved, would show that the $1.2 billion overstatement of equity in connection with a Raptor transaction entailed fraud by Andersen. Although plaintiffs assert that Andersen "knew" that "the accounting violated several accounting rules," they plead no facts relating to Andersen's knowledge of this error. Compl. ¶ 952. See Coates, 55 F. Supp. 2d at 634 (plaintiffs must plead "specific facts that make it reasonable to believe that defendant knew that a statement was false or misleading"). Such "rote conclusory allegations that the defendants 'knowingly did this' or 'recklessly did that' fail to meet the heightened pleading requirements of Rule 9(b)." Lovelace, 78 F.3d at 1019; accord Melder, 27 F.3d at 1104 (5th Cir. 1994). Similarly, plaintiffs do not allege that Andersen – much less any individual at Andersen – had any specific knowledge relating to the allegedly improper earnings derived from the Raptors. Their allegations regarding the amounts Andersen billed in connection with the Raptors fall far short of the requisite allegations of specific knowledge giving rise to a strong inference of scienter.

iii. Plaintiffs' Allegations Regarding Enron's Broadband Transactions Do Not Give Rise to a Strong Inference of Fraud by Andersen (Responding to Section G)

Plaintiffs allege that in order to "conceal the failure" of Enron's broadband division, Enron "engaged in several accounting manipulations with respect to broadband, including the

improper accounting for a deal with Blockbuster, the improper use of mark-to-market accounting for broadband transactions . . . and the improper recognition of income from inflated swaps of fiber optic capacity with other telcom companies." Compl. ¶ 520. Plaintiffs' assertions that Andersen was "consulted on," "reviewed," "signed off on," and was "involved in" Enron's allegedly improper accounting "all fall within the prohibitive bar of Central Bank." Shapiro v. Cantor, 123 F.3d at 720.

Further, plaintiffs fail to plead facts that show this allegedly improper accounting had a material effect on Enron's 2000 annual financial statement – the last Enron financial statement audited by Andersen. Although plaintiffs allege that "[i]n the 4thQ 00 and 1stQ 01, Enron improperly recognized income of $111 million," they fail to specify how much of this income was recognized in the fourth quarter of 2000, as opposed to the first quarter of 2001. Compl. ¶ 54. Under these circumstances, plaintiffs have not adequately pleaded the materiality of the challenged income to Enron's audited annual financial statements for 2000, the last statements audited by Andersen.

In any event, plaintiffs' allegations do not support a strong inference of scienter against Andersen. Plaintiffs nowhere allege that the use of mark-to-market accounting is inherently fraudulent; nor could they, as GAAP required the use of mark-to-market accounting for certain transactions. See EITF 98-10: Accounting for Contracts Involved in Energy Trading and Risk Management Activities, Nov. 18-19, 1998 (attached as Tab 57 to Master Appendix, dated May 8, 2002) (energy trading contracts generously should be marked to market). Neither Andersen nor an Andersen employee is mentioned even once in the nearly twenty five paragraphs in the Consolidated Complaint specifically devoted to a discussion of Enron's treatment of its broadband transactions. See Compl. ¶¶ 520-539, 546-48. Plaintiffs do not make any allegations

regarding what information was provided by Enron to Andersen concerning the broadband transactions and what Andersen employees knew about the broadband transactions, how such information demonstrated that the accounting was "improper" or when they knew it – much less that Andersen "consciously entertained doubts about the veracity of its client's financial disclosures." Reiger, 117 F. Supp. 2d at 1012. Although plaintiffs cite an e-mail message in which an Andersen partner refers to mark-to-market earnings as "intelligent gambling," Compl. ¶ 938, this does not constitute a recognition by Andersen that the use of mark-to-market accounting was inappropriate, let alone fraudulent. Indeed, the message does not even specifically associate the reference to mark-to-market accounting with any broadband transaction. See also Compl. ¶ 940 (failing to associate mark-to-market accounting at issue with broadband). Under these circumstances, plaintiffs have failed to plead any specific facts regarding Enron's broadband transaction that, if proved, would give rise to a strong inference that Andersen possessed scienter.

iv. Plaintiffs' Allegations of Inadequate Disclosures by Enron Do Not Support a Strong Inference that Any Individual at Andersen Possessed Scienter (Responding to Section J)

Plaintiffs assert conclusorily that "[c]ontrary to GAAP, Enron's disclosures were inadequate and contrary to GAAS, Andersen failed to require revision." Compl. ¶ 961. As demonstrated elsewhere, the matters that plaintiffs allege were inadequately disclosed were, on the contrary, all properly disclosed in Enron's financial statements. See Certain Defendants' Joint Brief Relating to Enron's Disclosures, dated May 8, 2002.

In any event, plaintiffs' allegations regarding Andersen's alleged "fail[ure] to require revision" of Enron's disclosures do not even come close to suggesting fraud by Andersen.

Plaintiffs allege that Andersen violated the provisions in GAAS that "[a]n independent auditor considers whether a particular matter should be disclosed *in light of the circumstances and facts of which he is aware at the time*," Compl. ¶ 957 (emphasis added), and that an auditor "satisfy himself on the basis of his professional judgment that [each material related party transaction] is adequately disclosed in the financial statements," Compl. ¶ 958. But as shown above, plaintiffs' allegations fail to identify individuals at Andersen who knew particular facts regarding certain transactions or entities at specific times. Absent such particularized allegations of fact, it is impossible to conclude "in light of the circumstances and facts of which [Andersen was] aware at the time" that Andersen misjudged the adequacy of Enron's disclosures in its audited financial statements, much less that Andersen engaged in intentional deception or exhibited recklessness so severe that it constitutes fraud.

2. Plaintiffs' Allegations Regarding Andersen's Prior Audits Do Not Bolster Their Fraud Claim in Connection with the Enron Audit (Responding to Section E)

Plaintiffs charge that "Andersen has a history of participating in major accounting frauds," Compl. at 455 (capitalization altered), based on allegations that Andersen previously settled securities litigation in connection with several audits of clients other than Enron, see Compl. ¶¶ 919-20. But Andersen's settlement of prior securities litigation is, of course, not probative of any fraudulent conduct in those cases, much less of any fraudulent intent in this entirely separate case. See, e.g., Fed. R. Evid. 408 advisory committee's note (evidence of offer of settlement "is irrelevant, since the offer may be motivated by a desire for peace rather than from any concession of weakness of position"). This is reflected in the Federal Rules of Evidence, which provide that evidence of settlement "is not admissible to prove liability for . . . the claim or its amount." Fed. R. Evid. 408; see also United States v. Hays, 872 F.2d 582, 588-

89 (5th Cir. 1989). Under these circumstances, plaintiffs' allegations regarding Andersen's prior settlements are irrelevant to this case.

Accordingly, plaintiffs have failed to state a federal securities fraud claim against Andersen.[11]

## II. PLAINTIFFS HAVE FAILED TO ALLEGE A CLAIM AGAINST ARTHUR ANDERSEN UNDER SECTION 11 OF THE SECURITIES ACT OF 1933

Plaintiffs' claim pursuant to Section 11 of the Securities Act of 1933 relates to four debt offerings between 1999 and 2001. Andersen's alleged liability is premised on its consent to the incorporation of its audit reports in the registration statements. See Compl. ¶ 1012. However, plaintiffs allege that Andersen consented to the inclusion of its report in only two of the four registration statements at issue. In particular, plaintiffs allege that Andersen "consented to the incorporation of its reports on Enron's financial statements . . . in Enron's Registration Statements for the Company's: . . . (vi) registration of ten million Exchangeable Notes filed on 7/23/99; . . . and (x) registration of $1.9 billion in Zero Coupon Convertible Senior Notes due 2021 filed on 6/1/01. . . ." Compl. ¶ 899. These allegations relate to the Enron 7% Exchangeable Notes and the Enron Zero Coupon Convertible Senior Notes. Compl. ¶¶ 612, 1006. Plaintiffs do not allege that Andersen consented to incorporation of its reports in the registration statements relating to the Enron Corporation 7.375% Notes offered on 5/19/99 pursuant to a registration statement allegedly effective on 2/5/99, or the 8.375% and 7.875% Notes offered on 5/18/00 pursuant to a registration statement allegedly effective on 2/5/99. See Compl. ¶¶ 612, 899, 1006. Section 11 imposes liability on an accountant "*who has with his consent been named* as having prepared or certified any part of the registration statement, or as

[11] Plaintiffs allege no conceivable factual basis for stating a claim against Andersen under Section 20(a) of the Securities Exchange Act of 1934.

having prepared or certified any report or valuation which is used in connection with the registration statement." 15 U.S.C. § 77k(a)(4) (emphasis added). Since plaintiffs fail to allege the requisite consent with respect to two of the offerings, they have not alleged an essential element of their claim.[12]

Ordinarily, there is a presumption of reliance by the purchaser on the registration statement. However,

> "[i]f such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the *effective date of the registration statement*, then the right to recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of the omission."

15 U.S.C. §77k(a)(5) (emphasis added). "Purchasers prior to such a statement need not prove reliance on the registration statement, but subsequent purchasers must prove reliance, which makes their case substantially more difficult." In re U.S. Fin. Sec. Litig., 64 F.R.D. 443, 455 (S.D. Cal. 1974).

According to its certification, which has been incorporated into the Complaint, Compl. ¶ 81(g), the earliest date Amalgamated Bank purchased 7.375% Notes was on February 23, 2001. The alleged effective date of the registration statement was February 5, 1999, over two years earlier. See Compl. ¶ 612. Accordingly, Enron issued its 10-K for 1999, dated March 30, 2000,

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[12] With respect to the 8.375% Notes, it is also significant that neither of the two sub-class representatives, Hawaii Laborers and Archdiocese, purchased these notes. See Compl. ¶ 81(d), (o) and the accompanying certifications incorporated therein. Absent allegations that a plaintiff actually purchased these securities, plaintiffs cannot sustain a claim based on any alleged misstatements in a registration statement relating to these notes. See 15 U.S.C. 77k(a) (defining a person possessing a Section 11 claim as a person "acquiring such security"); In re Paracelsus Corp. Sec. Litig., 6 F. Supp. 2d 626, 631 (S.D. Tex. 1998) (holding that "plaintiff bringing suit under either Section 11 or Section 12 of the Securities Act at least must allege that he or she purchased or acquired the security at issue," and dismissing the Section 11 claim for failure to state a cause of action where named plaintiff had not acquired the notes at issue).

as well as three 10-Q's for 2000, see Compl. ¶ 221; SEC App. Tabs 10, 12-14, after the effective date of the registration and prior to Amalgamated Bank's purchase. Notwithstanding these intervening earning statements, plaintiffs fail to plead the requisite reliance by Amalgamated Bank.[13] Similarly, Hawaii Laborers and Archdiocese did not purchase the 7.875% Notes prior to June 2000, see Compl. ¶ 81(d), (0) and certifications incorporated therein, well over a year after the alleged effective date of the relevant registration statement on February 5, 1999, see Compl. ¶ 612. During that period Enron issued its 10-K for 1999 as well as the first quarter results for 2000. See Compl. ¶ 221; SEC App. Tabs 10, 12. Although not entitled to a presumption of reliance, plaintiffs again failed to include allegations setting forth this essential element to their claim. Because these plaintiffs acquired the Notes after earning statements for at least a twelve-month period subsequent to the effective date of the registration statements became available, and because there are no allegations that these plaintiffs relied on the registration statements, these claims should be dismissed. See In re Am. Cont'l Corp./Lincoln Sav. and Loan Sec. Litig., 794 F. Supp. 1424, 1435 (D. Ariz. 1992) (requiring proof of reliance where plaintiff acquired securities after issuer made generally available an earning statement covering a twelve month period commencing after the effective date of the registration statement); accord In re Gap Stores Sec. Litig., 79 F.R.D. 283, 297 n.14 (N.D. Cal. 1978) (same).

The allegations are also insufficient with respect to the Enron 7% Exchangeable Notes. Murray van de Velde, the purported sub-class representative, purchased these notes on November 5 and 9, 2001. See Compl. ¶ 81(f) and certification incorporated therein. However, the alleged effective date of the relevant registration statement was July 23, 1999, over two years earlier.

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[13] Although the complaint generally alleges a purported fraud-on-the-market theory of reliance, Compl. ¶¶ 983-84, plaintiffs expressly disclaim any fraud allegations in connection with their Section 11 claim. Compl. ¶ 1005.

See Compl. ¶ 612. Accordingly, Enron released its 10-K for 1999 dated March 30, 2000 and its 10-K for 2000, dated April 2, 2001, as well as 10-Q's for the first two quarters of 2001 during the intervening period. See Compl. ¶¶ 221, 292; SEC App. Tabs 10, 15, 17-18. Accordingly, as with Amalgamated Bank and Hawaii Laborers, plaintiffs were required to plead reliance by Van de Velde on the registration statement, but have failed to do so. Therefore, plaintiffs have failed to state a Section 11 claim against Andersen, and this cause of action should be dismissed.[14]

## III. THE CONSOLIDATED COMPLAINT FAILS TO ADEQUATELY ALLEGE A CLAIM AGAINST ANDERSEN UNDER THE TEXAS SECURITIES ACT

Only "[a] person who offers or sells a security," "[a] person who offers to buy or buys a security," or "an issuer who registers . . . its outstanding securities for offer and sale by or for the owner of the securities" is potentially liable as a principal under Article 581-33 of the Texas Securities Act. Tex. Civ. Stat. art. 581-33A to -33C. Secondary liability is limited only to persons with scienter who "materially" aid a primary violation. The Statute provides in pertinent part:

> "A person who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a seller, buyer or issuer of a security is liable under Section 33A, 33B, or 33C jointly and severally with the seller, buyer, or issuer, and to the same extent as if he were the seller, buyer or issuer."

Id. art. 581-33F(2). Plaintiffs do not allege that Andersen is a seller, buyer or issuer of any Enron securities. Therefore, plaintiffs' assertion of an Article 581-33 claim against Andersen must be premised on a theory of secondary liability. This requires plaintiffs to allege "intent to deceive or

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[14] As with the §20(a) claim under the 1934 Act, plaintiffs make no allegations that Andersen is a controlling person as such term is defined by Section 15 of the 1933 Act, and, thus, do not state a claim against Andersen under Section 15.

defraud" or "reckless disregard for the truth or the law." Because this claim sounds in fraud, it is subject to Federal Rule of Civil Procedure 9(b). See Fed.R.Civ.P. 9(b) ("In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity."); Lone Star Ladies Invest. Club v. Schlotzsky's Inc., 238 F.3d 363, 368 (5th Cir. 2001) ("Rule 9(b) applies by its plain language to all averments of fraud, whether they are part of a claim of fraud or not.").

In order to establish aiding and abetting liability under the Texas Securities Act, "a plaintiff must demonstrate 1) that a primary violation of the securities laws occurred; 2) that the alleged aider had general awareness of its role in this violation; 3) that the actor rendered substantial assistance in this violation; and 4) that the alleged aider either a) intended to deceive plaintiff or 2) acted with reckless disregard for the truth of the representations made by the primary violator." Frank v. Bear, Stearns & Co., 11 S.W.3d 380, 384 (Tex. App. 2000) (internal quotations and citations omitted); accord Crescendo Invs., Inc. v. Brice, 61 S.W.3d 465, 472 (Tex. App. 2001). The Consolidated Complaint does not adequately set forth these basic elements which make out a claim under this statute.

While this claim is brought against several defendants, including institutional and individual defendants, the allegations are deliberately vague concerning what role each defendant played – *i.e.*, seller, issuer, aider, or otherwise – and the manner in which they allegedly violated the statute. See Compl. ¶¶ 1017-30. Plaintiffs do not even specify on which sections of Article 581-33 they rely or their theory of liability as to any particular defendant. As such, plaintiffs allegations clearly fail to meet the requirements of Fed.R.Civ. P. 9(b) and even the liberal pleading standards of Rule 8.

Although plaintiffs identify JP Morgan and Lehman Brothers as the sellers of the 6.95% and 6.40% Notes, see Compl. ¶ 1023, there are no allegations linking Andersen to the sellers, making it difficult to conceive how Andersen could be liable for aiding and abetting a seller with which it had no alleged contact. Moreover, even if plaintiffs have sufficiently alleged a primary violation by the sellers of the Notes, plaintiffs have not satisfactorily plead Andersen's knowledge of the violation or substantial assistance on the part of Andersen. There are no allegations suggesting that Andersen was aware or had knowledge of a violation by JP Morgan or Lehman Brothers, or that it somehow had a role in the banks' alleged violations. See Frank, 11 S.W.3d at 384 (holding that the aider and abettor must be aware of the primary violation). Nor do plaintiffs allege how Andersen materially aided the primary violation or that it had an intent to deceive. Plaintiffs allege no more than that Andersen "consented to the incorporation of its reports on Enron's financial statements" in certain registration statements. See Compl. ¶ 899. This simply does not rise to the level of substantial assistance nor does it demonstrate an intent to deceive or a reckless disregard for the truth of the representations. "To be an aider and abettor, there must be evidence of general awareness and substantial assistance of the *violation* with the necessary intent." Crescendo Invs., 61 S.W.3d at 473 (emphasis in original). Plaintiffs have not alleged particularized facts that, if proved, would show that Andersen knowingly, and with scienter, aided and abetted any alleged fraud by the sellers.

Similarly, plaintiffs do not sufficiently allege that Andersen materially aided any alleged fraud by Enron as the issuer. As an initial matter, issuer liability extends only to an issuer which registers "its outstanding securities for offer and sale by or for the owner of the securities." § 531-33 C(1). Plaintiffs fail to allege who the owner of the securities was. This omission notwithstanding, the notion that Andersen was complicit in a fraud perpetrated by Enron is not

supported by the allegations. Cursory allegations that Andersen "reviewed," "discussed," "approved," "examined and opined," and "was consulted on," Enron's financial statements and transactions, and "consented" to inclusion of its reports in certain registration statements, see Compl. ¶¶ 897, 899, 905, 935, do not constitute particularized allegations of fact that, if proved, would demonstrate that Andersen "materially aid[ed]" in alleged fraud by Enron, much less demonstrate intent to deceive. These generalized allegations merely describe the role of any independent auditor.

For these reasons, plaintiffs have failed to state a claim for violation of the Texas Securities Act.[15]

## IV. THE CONSOLIDATED COMPLAINT FAILS TO STATE A CLAIM AGAINST "ARTHUR ANDERSEN-PUERTO RICO"

To the extent plaintiffs allege that there is an entity called "Arthur Andersen-Puerto Rico" that is a separate entity from Andersen, see Compl. ¶ 92(c), the Consolidated Complaint fails to state a claim against Arthur Andersen-Puerto Rico. The Consolidated Complaint contains only a single reference to Arthur Andersen-Puerto Rico:

> "Defendant Arthur Andersen-Puerto Rico ("Andersen-Puerto Rico") is part of Andersen-Worldwide. Andersen-Puerto Rico participated in the [19]97-[20]00 audits of Enron."

Compl. ¶ 92(c). Plaintiffs fail to allege that Arthur Andersen-Puerto Rico made any publicly attributable statements about Enron on which they relied, so Arthur Andersen-Puerto Rico faces

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[15] Additional state law claims are alleged in certain of the consolidated Newby cases, but are not incorporated into the consolidated complaint. Accordingly, Andersen is not obligated to respond to these claims at this time. As set forth more fully in Certain Defendants' Motion to Strike the First Amended Complaint in Wilt v. Fastow and in Defendants' Motion for Entry of Preliminary Scheduling Order for Complaints Consolidated into Newby and Pursued by Persons Other Than Court-Appointed Lead Plaintiff (which are being filed simultaneously with Andersen's Motion to Dismiss), the December 12, 2001 consolidation order, and the subsequent scheduling orders require only that Andersen respond to the Consolidated Complaint. At such time, if ever, that the Court orders defendants to respond to these state law claims, Andersen will move to dismiss these claims for failure to state a cause of action.

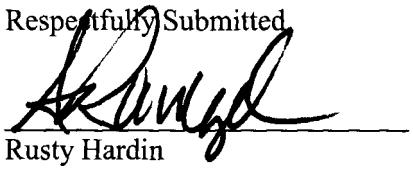
no potential liability to plaintiffs under Section 10(b) of the Exchange or Rule 10b-5 promulgated thereunder. See, e.g., Wright, 152 F.3d at 175. Further, plaintiffs do not allege that Arthur Andersen-Puerto Rico ever granted Enron consent to use its name in connection with any audited financial statements in a registration statement. Thus, plaintiffs have failed to state a claim against Arthur Andersen-Puerto Rico under Section 11 of the Securities Act of 1933. See 15 U.S.C. § 77k(a)(4) (imposing liability on an accountant "*who has with his consent been named* as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement") (emphasis added). Finally, because plaintiffs fail to allege – much less plead particularized facts that, if proved, would show – that Arthur Andersen-Puerto Rico "with intent to deceive or defraud or with reckless disregard for the truth or the law materially aid[ed]" a primary violator of the Texas Securities Act, plaintiffs have not stated a claim against Arthur Andersen-Puerto Rico under that Act. See Tex. Civ. Stat. art. 581-33 F(2); see also Lovelace, 78 F.3d at 1018 ("In order to adequately plead scienter [under Rule 9(b)], a plaintiff must set forth specific facts to support an inference of fraud."). For these reasons, the Consolidated Complaint fails to state a claim against Arthur Andersen-Puerto Rico.

## CONCLUSION

For these reasons, plaintiffs' Consolidated Complaint fails to state a claim against Andersen upon which relief may be granted and should be dismissed against Andersen pursuant to Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure.

Dated: Houston, Texas
May 8, 2002

Respectfully Submitted,



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**CERTIFICATE OF SERVICE**

I hereby certify that on this 8th day of May, 2002, the forgoing pleading was served pursuant to the Court's April 5, 2002 Order.

Andrew Ramzel

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

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|---|---|---|
| In Re ENRON CORPORATION SECURITIES LITIGATION | § | |
| MARK NEWBY, et al., Individually and On Behalf Of All Others Similarly Situated | § | Civil Action No. H-01-3624 And Consolidated Cases |
| vs. | § | |
| ENRON CORP., et al. | § | |
| THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, et al., Individually and On Behalf of All Others Similarly Situated, | § | |
| v. | § | |
| KENNETH L. LAY, et al. | § | |

ORDER

The Court grants Arthur Andersen, L.L.P.'s ("Andersen") Motion To Dismiss The Consolidated Complaint, and dismisses with prejudice and in its entirety Plaintiffs' Consolidated Complaint For Violation of The Securities Laws as against Andersen.

Signed this _____ day of _____, 2002.

_____
Melinda Harmon
United States District Judge